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Nos. 83-1321, 83-1432, 83-1433,
83-1442, 83-1443 & 83-1618

IN THE

Supreme Court of the United States

OCTOBER TERM, 1983

THE PEOPLE OF THE STATE OF CALIFORNIA, *et al.*,
Petitioners,

v.

TENNECO OIL COMPANY, *et al.*,
Respondents.

JOINT REPLY BRIEF IN SUPPORT OF PETITIONS FOR WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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1. The Public Importance Of This Case

Producers' principal defenses are that the case is "prospectively moot" because gas consumers (as opposed to the pipelines) face no risk of future exploitation and that refunds to consumers for exploitation in the past are uncertain. These defenses are without merit.[1]

[1] Producers also contend that the GLA/PLA transactions are *sui generis*. There is no evidence in the record, however, that the GLA/PLA transactions, along with the lease sales found jurisdictional in the 1960s, are the entire universe of jurisdictional lease sale transactions. An assertion to that effect would be incorrect.

Mid-La[2] did not change the statutory duty of the FERC[3] under the NGA[4] or the NGPA[5] to regulate sales of gas by producers. *FPC* v. *Texaco, Inc.*, 417 U.S. 380, 394 (1974) ("No producer is exempt from §§ 4 and 5."). Indeed, the protection of gas consumers from exploitive prices requires that the FERC regulate the producer as well as the pipeline. "Control limited to approving the costs of the gas to the purchasing pipeline is, of course, not an effective way to regulate producer prices because in the large a pipeline must be allowed to pass on its purchased gas costs to the ultimate consumer or it cannot continue to discharge its public service responsibilities." *Texas Eastern Transmission, Corp.*, 29 F.P.C. 249, 255-56 (1963) (FPC's *Rayne Field* decision). "Throughout the years in controversies such as *Phillips* and *CATCO*, the FPC has sought to justify inaction at the level of producer rates on the ground that the pressures built up by producer rate increases could somehow be contained at the pipeline level by invoking a regulatory agency's authority to disallow 'excessive' costs. And throughout the years, the [Supreme] Court has found this professed substitute inadequate." *Consumer Federation of America* v. *FPC*, 515 F.2d 347, 357-58 (D.C. Cir.), *cert. denied*, 423 U.S. 906 (1975). According to this Court, ". . . rates are 'just and reasonable' only if consumer interests are protected and if the financial health of the pipeline in our economic system remains strong." *FPC* v. *Memphis, Light, Gas & Water Div.*, 411 U.S. 458, 474 (1973).

If the decision below is not reversed, the GLA producers and the non-settling PLA producers will long continue to reap windfalls never contemplated by Congress under the NGA or the NGPA. Moreover, El Paso anticipates that the GLA producers, unless restrained by regulation, will contend that their special overriding royalty should just about *triple* on and after

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[2] Public Service Comm'n of New York v. Mid-Louisiana Gas Co., 103 S. Ct. 3024 (1983).

[3] Federal Energy Regulatory Commission.

[4] Natural Gas Act, 15 U.S.C., §§ 717-717w (1982).

[5] Natural Gas Policy Act of 1978, 15 U.S.C. §§ 3301-3432 (1982).

June 1, 1985. It is obvious that El Paso will ask gas consumers to shoulder the impact of such a dramatic escalation of an already excessive payment.[6] On Northwest's system, Phillips and Getty have accepted regulated prices, under settlements approved by the FERC, but the other PLA producers (Amoco, Atlantic, Mobil) like the GLA producers claim that they should receive several times more than these maximum lawful prices. If Northwest is required to pay these excessive demands, it will have no alternative but to seek from the FERC special relief permitting it to pass these payments onto ratepayers.

Accordingly, if the Court of Appeals opinion stands, its economic impact will extend far into the future. There are still

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[6] The representation of Tenneco, *et al.* of no prospective consumer impact is disingenuous. In the Texas state court litigation, Tenneco's expert testified that "El Paso would have an excellent chance of having [special relief] granted . . . ." El Paso Natural Gas Co. v. Tenneco Oil Co., No. 83-50539, 11th Judicial District, Harris County, Texas, transcript of January 26, 1984, p. 105. The Commission in approving the Phillips-Northwest PLA 5 settlement (discussed in the text, *infra*), noted that "Phillips is offering to accept rates under PLA 5 that could save Northwest, *and eventually its consumers*, as much as $50,000,000 a year." 25 FERC ¶ 61,292 at 61,674 (1983) (italics added). Thus, the FERC recognized that it is uncertain that the pipelines will bear the entire cost of high special overriding royalties in the future if the GLA/PLAs are not jurisdictional sales. The producers point out that El Paso presently offsets GLA production losses against profitable production on non-GLA properties. Producers' contention is irrelevant; the fact that El Paso has other profitable operations in no way justifies producers' continuing receipt of unregulated revenues in violation of the NGA and NGPA. Producers in their argument that El Paso and not the consumers can bear the future impact cite a study prepared for a different purpose by El Paso's reservoir engineering department. The study did not take into account the dramatic increase in the special overriding royalty that producers will seek after June 1, 1985. As of this time, El Paso has not sought special relief, but, contrary to the assertion in Tenneco's Brief at 10 n.19, El Paso's witnesses did *not* testify in the Texas state court case that the FERC would likely deny special relief if reassignment failed. (They testified that the FERC would likely deny special belief so long as El Paso had reassignment rights which it could exercise—rights which the state court subsequently said could not be exercised.) The only way to ensure that the consumer does not face substantial increased costs in the future is through a jurisdictional decision in this case.

some 3 trillion cubic feet of gas under the GLA/PLA leases,[7] and production from these leases, burdened with high special overriding royalties allowed under the Fifth Circuit's decision, will continue for 20 years or more. The FERC, required to protect both gas consumers and the legitimate interests of pipelines, will be confronted with unsatisfactory choices for either, guaranteeing endless litigation.

Producers try to minimize the amount of the refunds claimed in the FERC remedy proceeding, but it is obvious that the producers have been paid far more than they should have been paid in the past. If the decision below is reversed, petitioners will have the opportunity in an FERC remedy proceeding to prove that the GLA producers must refund more than $1 billion for the benefit of gas consumers on El Paso's system and, excluding Phillips and Getty, $50 million for Northwest's consumers.[8] Producers assert that these refund claims are exaggerated, and point to the $32 million refund that Phillips and Getty have agreed under their settlements to make to Northwest's consumers in the event of a jurisdictional determination by this Court. However, these settlements were made after the decision of the Fifth Circuit and represent a substantial compromise of past refund liability given in return for Phillips' and Getty's agreement to accept in the future regulated pricing, including an "old gas" price, less North-

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[7] Last year, the city of Washington, D.C. consumed 292,354,000 therms of natural gas. At the 1983 consumption rate, 3 Tcf would supply the city of Washington for more than 100 years.

[8] The Commission unquestionably has the power to order refunds in this case, and could restructure the agreements from their inception, as it did in the *Rayne Field* remedy case. Public Service Comm'n of New York v. FPC, 543 F.2d 757 (D.C. Cir. 1974), *cert. denied*, 424 U.S. 910 (1976). Petitioners and the FERC Staff have sought refunds only back to 1974 when producers were placed on notice of their liability. The 1974 Settlement Agreements provided that the payments made under the agreements were subject to Commission order in the event of a final jurisdictional determination. Even if the producers were somehow successful in fixing the commencement of their liability at the date of the FERC's jurisdictional decision in 1980, they would still be subject to refunds of about $500,000,000.

west's cost of producing the gas.[9] As a consequence, Phillips and Getty today are paid about 86¢ per MMBtu less Northwest's production costs per MMBtu for "old gas," whereas the GLA producers are receiving an incentive "new gas" price, now $3.35 per MMBtu less 7¢, for all gas, including "old gas."

In providing for incentive pricing under the NGPA, Congress never intended that producers in an established field, such as the San Juan Basin, could obtain such high prices for "old gas." Yet, this has happened and will continue to happen unless this Court closes the regulatory gap opened up by the court below.

2. The Lease Sales Were Jurisdictional Sales

Producers, citing the FERC Petition at 19, agree with the Commission that "the dispositive question [under *Rayne Field*] is whether what was sold was gas or merely the right to explore for gas." PLA Respondents' Brief at 13; Union Brief at 15. The producers claim that only the right to explore for gas was transferred under the GLA/PLA lease sales, even though the pipelines could not have been certificated, financed and built or expanded unless the GLA/PLA reserves were found to be proven[10] and immediately available upon completion of the

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[9] Phillips and Getty in effect accepted the pricing remedy for the future proposed by Northwest in the aborted FERC remedy case. The Commission found that "the settlement assures ratepayers secure future rates in return for the giving up of *substantial refunds* in the event the Former Fifth Circuit is reversed." 25 FERC ¶ 61,292 at 61,674 (1983) (italics added). The Commission was here referring to pre-1980 refunds. These two settlements provided for full refunds back to September 1980 contingent upon a final jurisdictional decision. Further, in the event of a jurisdictional determination, Phillips and Getty agreed that they may be required to accept a lower old gas price than is now used for valuing their old gas.

[10] As of 1951, the American Gas Association defined "proved reserves" as follows: "Proved reserves may be in either the drilled or undrilled portions of a given field. Where the undrilled areas are considered proved, they are so related to the developed acreage and to the known field geology and structure that their productive ability is considered assured. Proved recoverable reserves of natural gas are the reserves estimated to be producible under present operating practices." Report of The Committee on Natural Gas

pipeline facilities to provide the certificated gas service.[11] Judge Benkin specifically found that the reserves under each GLA/PLA were proven,[12] the FERC adopted his findings, and, despite producers' obfuscations,[13] the Fifth Circuit did not upset the agency's expert finding that the reserves were proven. In the case of GLA 47, this Court can see that the acreage transferred by Delhi was proven from the map submitted by Tenneco.[14] Thus, producers' contention that merely rights to explore unproven lands rather than proven gas reserves were sold under the GLA/PLA transactions is in con-

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Reserves of the American Gas Association, Year Ended December 31, 1951. A prudent operator in a proven area will therefore always drill a commercial well. R. 908, 1507.

[11] In the San Juan Basin, a development well in the 1950s required 30 days or less to drill. The development wells were drilled while the pipelines' gathering systems were being extended. Neither producer nor pipeline drills development wells ahead of the time that the pipeline can tie into the well. *See* El Paso Petition, No. 83-1442, at 6 nn.3 and 4.

[12] App. 52a-56a, 106a-07a.

[13] An example is Tenneco's Brief at 7 n.15. DeGolyer & MacNaughten specifically found the GLA 47 reserves were proven, as discussed in the PGandE and SoCalGas Petition, No. 83-1443 at 10-11. The California companies were seeking yet additional supply in the Basin. The memorandum cited by Tenneco in note 15 makes the point that additional drilling was needed to prove up reserves *beyond* the then established field limits in order for the entire Blanco area to be proven. This drilling was underway. *See* note 14, *infra*. Another example is the PLA producers' characterization that Amoco's PLA acreage was "an awful lot of goat pasture." PLA Respondents Brief at 21 n.29. An Amoco witness testified before Judge Benkin that Amoco's predecessor Stanolind transferred proved reserves. R. 1909, R. 1920.

[14] Outlined in red on the map lodged by Tenneco with this Court are the Mesaverde field limits as determined by El Paso and the state of New Mexico in early 1952. Field limits delineate the areal extent of proven reserves. Delhi's acreage is colored blue on the map. R.21053 All blue acreage within the red line was proved, according to El Paso and the state of New Mexico (as well as Delhi), at the time. R. 21053 This acreage, according to Delhi, contained proven, recoverable reserves of 1.063 Tcf. R.9692 Subsequent drilling in the 1950s rapidly expanded the proven field limits to include several times the proven area shown on the map. El Paso and Northwest conclusively showed that proven reserves were assigned under each GLA/PLA transaction. *E.g.*, R. 9971-10038.

flict with the findings of the agency accepted below. These agency findings, supported by substantial evidence, were conclusive on the court below. NGA § 19(b), 15 U.S.C. § 717r(b).

Because the GLA/PLA reserves were proven,[15] the producers knew the economics (reserves, capital cost, operating expense) of producing the gas, and therefore structured lease sales that returned to them the same net income that they would have received under conventional sales.[16] The cost of development drilling was simply one of a number of factors taken into account in calculating the payment to be received by the producers, just as in *Rayne Field*, *Bastian Bay*, and *Ship Shoal* (see appendix).[17] The FERC's findings of proven reserves and economic equivalence, both of which were accepted by the court below, means that the producers sold gas and not the right to explore for gas through the lease sale transfers. *See* App. 109a-110a. The absence of any particular number of development wells cannot change this dispositive fact.

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[15] See definition of proven reserves in note 10, *supra*.

[16] Delhi's studies demonstrating this fact are in evidence (R. 9692, R. 5130); Union's predecessor made the same determination (R. 20787); Skelly estimated that it would receive two cents more per Mcf than under a conventional wellhead sale (R. 12870); C. E. Turner, a Phillips economist, testified that the lease sale "was just about as good or better than [Phillips] could [obtain] by drilling the acreage [itself], and selling the gas from day to day." R. 14279.

[17] Producers here seek to distinguish the trilogy on various hairsplitting grounds that the expert agency rejected as without merit. App. 105a-107a. For example, the only purpose of the "upfront" payment in Ship Shoal was to reimburse the producers for capital investment, just like the payments for existing wells here. R. 5149 In fact, the GLA 47 and Ship Shoal transactions are remarkably close, as shown by the Appendix to this Reply. Producers also misstate the facts of Ship Shoal; at closing, 12 wells, not 17, had been drilled: "One gas well has been completed; it has been and still is shut-in with no gas produced (J.A. 4-5). Seven oil wells have been completed and have been producing since 1960 (ibid.). Four dry holes had been drilled (ibid.)." Producers' Petition for Certiorari, Continental Oil Co. v. FPC, No. 1323, October Term, 1966, pp. 3-4; see also Tennessee Gas Transmission Co., 30 F.P.C. 759, 799 (1963). The five potential gas wells were drilled by the pipeline after closing, not by the producers. 30 F.P.C. at 803.

Producers do not attempt to defend the Court of Appeals' decision that in order for a lease sale of gas to be jurisdictional there must be present on the leasehold sufficient development wells to deplete the proven reserves. Rather, producers argue that unless substantial development exists the lease sale fails the proven reserve requirement or the economic equivalent test. Tenneco contends that unless substantial development exists "a sale of gas in place is impossible because a definable volume of gas is uncertain, and estimates of reserves cannot be relied upon by the parties to the transfer." Tenneco Brief at 13. Similarly, the PLA producers maintain that this Court in *Rayne Field* required substantial development for "verification of the estimated reserves thought to underlie the acreage" in order to have a sale of gas. PLA Respondents' Brief at 14. On the other hand, Union, alone in acknowledging the lower court's treatment of substantial development as a jurisdictional requirement, separate and apart from whether reserves are proven, asserts that if the "risks and expenses" of development wells[18] are transferred to the buyer "then the lease sale simply cannot be economically equivalent to the sale of gas." Union Brief at 16, 17.

The failure of the producers directly to defend the decision below underscores its gross misapplication of *Rayne Field*. In fact, under the Tenneco-Phillips rationale, *Rayne Field* could *never* have been a jurisdictional lease sale. In 1959, at the time of that lease sale, "a major unknowable was the volume of gas which the transferred reserves would ultimately yield, and consequently the eventual unit price which Texas Eastern would pay for the yield." *Public Service Comm'n of New York* v. *FPC*, 543 F.2d 757, 783 (D.C. Cir. 1974), *cert. denied*, 424 U.S. 910 (1976) (*Rayne* remedy case).[19] In connection with

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[18] When the reserves are proven, there is no significant risk in drilling development wells. See note 10, *supra*. The risk is in drilling exploratory wells, *not* development wells. R.908.

[19] The producers, as well as the Fifth Circuit, know that reserve estimates vary considerably and that substantial development is not required to verify proven reserve estimates traditionally relied upon by producers, pipelines the Commission, and lenders. See Ship Shoal, 370 F.2d at 65 ("We recognize

Union's position, the evidence here showed that the producers structured the economic equivalent of a conventional sale without development wells,[20] and the court below never disputed the agency's finding of equivalence.

It is indefensible to deny jurisdiction over lease sales which the Commission found based on substantial evidence to be assignments of proven reserves that were economically equivalent to conventional sales simply because the pipelines were required by the producers to drill the development wells. If primary jurisdiction means anything, the court below should surely have deferred to the agency's judgment that development drilling was not needed here to accomplish jurisdictional sales of gas by these lease sales.[21]

3. Producers Are Not Royalty Owners

Producers here seek refuge under the *Mobil* case.[22] They contend that they are nothing more than passive royalty owners who engaged in unregulated land transactions even though such royalty owners typically are paid on 12½% of the value of the production, whereas the GLA and PLA producers are paid on 70% to 85% of the value of the production. True royalty owners, such as the respondent farmers in the market value royalty cases currently pending before this Court,[23] under-

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that estimates of reserves in Ship Shoal may vary considerably until the field is fully drilled and there is productive history over a period of years under operating conditions.").

[20] See note 16, *supra*.

[21] In Ship Shoal, the producers also argued that the reserves were unproven, and there were no gas development wells. Nevertheless, the court affirmed the agency's jurisdictional determination without any development wells because of the purchasing pipeline's "willingness to invest over $97 million on its faith in the lowest of the reserve estimates" and because "its readiness to connect its lines to *Ship Shoal* is a strong indication that the field was 'substantially developed' at the time of transfer." 370 F.2d at 65. The GLA/PLA transactions had similar and considerably more persuasive facts.

[22] Mobil Oil Corp. v. FPC, 463 F.2d 256 (D.C. Cir. 1971), cert. denied, 406 U.S. 976 (1972).

[23] Nos. 83-1234, 83-1248 & 83-1278.

stand the vast difference between themselves and the producers. As the farmers inform this Court:

> Overriding royalty interest owners, as sellers of gas or leases, such as producer-respondents in Nos. 83-1321, 83-1433 and 83-1618, may of course be subject to the Commission's jurisdiction under the National Gas Act. Not even a transparent similarity exists between respondent landowners' rental involved herein and the producers' overriding royalty interests as lessees in Nos. 83-1321, 83-1433 and 83-1618.[24]

Because the GLA/PLA producers are paid on the entire net interest assigned, they are capturing more than 400% of the regulated value of the gas, as opposed to the situation in the market value royalty cases where several of these same producers complain about the landowner capturing 60% of the regulated value.[25] The GLA/PLA reserves remain a major and necessary gas supply for western gas markets. It is imperative that this Court ensure that the producers' continuing exploitation of consumers and pipelines dependent on this supply be brought to a halt.

4. Conclusion

The petitions should be granted.

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[24] Brief of Respondents in Opposition, Ashland Oil Co. v. Good, et. al., Nos. 83-1234, 83-1248 & 83-1278 at 21 n.18.

[25] See FERC Petition for Cert., FERC v. Tenneco Oil Co., No. 83-1618 at 22 n.17, where the FERC explains that the financial impact here far exceeds that in the market value royalty cases.

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APPENDIX

Comparison of GLA 47/Ship Shoal

	GLA 47	Ship Shoal
1. Recoverable Reserves As Estimated By Producer *Before* Lease Sale Execution	1.063 Tcf (R.9692)	730 to 823 Bcf (370 F.2d at 65)
2. Reserves Producible In Four Years As Estimated By Producer	16.8% (or 179 Bcf) (R.9692)	10% (or 73 to 82.3 Bcf) (370 F.2d at 66)
3. Estimated Life Of Property	25 years (R.9692)	26 years (30 F.P.C. at 803)
4. Specified Development Program	Yes (R.4098-101)	Yes (R.14169)
5. Capital Investment[1] Over Life Of Reserves	$20,000,000 (R.9692)	$13,104,000 (30 F.P.C. at 803)[2]
6. Capital Investment At Closing	$1,021,000 (R.5149)	$1,999,000 (30 F.P.C. at 803)
7. Closing Payment[3]	$1,021,000 (R.5149)	$1,925,000 (30 F.P.C. at 801)
8. Pipeline Operating Expense Over Life Of Reserves As Estimated By Producer	$595,000 (R.9692)	$31,009,000 (30 F.P.C. at 803)
9. Method Of Payment	Cents Per Mcf as produced	Advance payments as scheduled by notes

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[1] As used in this comparison, "capital investment" means the amount invested in depreciable gas property.

[2] $1,999,000 at closing ($2,280,000 × 87.6712%) + 8,260,000 + 2,845,000. 30 F.P.C. at 803.

[3] The producers call this the "upfront payment." It is exactly the same as capital investment at closing in GLA 47 and nearly the same in Ship Shoal.

Comparison of GLA 47/Ship Shoal

	GLA 47	Ship Shoal
10. Reserve Redetermination	No[4]	Yes,[5] in 7th year
11. Overall Consideration For Reserves	Net interest payment[6] (geared to production) + capital and operating costs shifted to pipeline	Net interest payment (geared to production) + capital and operating costs shifted to pipeline

[4] Not needed as payment per Mcf.

[5] The purpose was to enable the parties to readjust the price depending on remaining reserves as estimated upon significant production history.

[6] In jurisdictional lease sale transfers of the type involved here, the producer assigns the working interest to the pipeline, and the pipeline then bears the royalty expense. The producer is paid on the entire volume remaining after subtraction of royalty volume. This payment at least in the early years is less than the field or in-line price in recognition that under the lease sale form capital and operating costs have been shifted to the pipeline.